

Internal Revenue Service

Department of the Treasury

Index Number: 355.01-01, 368.04-00,
1362.00-00

Washington, DC 20224

Number: **200039021**
Release Date: 9/29/2000

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Refer Reply To:
CC:DOM:CORP:3- PLR-106771-00
Date:
June 27, 2000

Re:

Distributing =

Controlled =

business m =

State X =

Date a =

Shareholder A =

Shareholder B =

aa =

bb =

This is in response to a letter dated March 7, 2000, for rulings concerning the federal income tax consequences of a proposed transaction. Additional information was submitted May 18, 2000 and May 26, 2000. The material information submitted for consideration is summarized below.

Distributing, a State X corporation, is currently engaged in business m and uses the cash method of accounting. Distributing made an election to be treated as an S Corporation effective on Date a. Distributing has two shareholders, Shareholder A and Shareholder B, who own aa% and bb% interests, respectively. Controlled will be a separate and independent State X corporation also engaged in business m, using the cash method of accounting, and plans to elect to be treated as an S corporation.

We have received financial information indicating that business m of Distributing has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Significant disagreements between Shareholder A and Shareholder B have taken place which have adversely effected the management and operations of Distributing. Accordingly, the directors of Distributing propose the following transaction.

(1) Distributing will form Controlled as a wholly owned subsidiary.

(2) Distributing will transfer certain assets and liabilities to Controlled, constituting aa% of all assets and associated liabilities that Distributing owns.

(3) Distributing will distribute all of the Controlled stock to Shareholder A in exchange for all of Shareholder A's Distributing stock.

Following the transaction Controlled will be wholly owned by Shareholder A and Distributing will be wholly owned by Shareholder B.

The taxpayers have made the following representations in connection with the transaction:

(a) The fair market value of the Controlled stock to be received by Shareholder A will be approximately equal to the fair market value of the Distributing stock surrendered in the exchange.

(b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.

(c) The 5 years of financial information submitted on behalf of Distributing is representative of Distributing's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted concerning business m.

(d) Following the transaction, Distributing and Controlled will each continue independently and with its separate employees, the active conduct of its share of all the integrated activities of business m.

(e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to resolve management deadlock and alleviate associated inefficiencies. The distribution of the stock of Controlled is motivated, in whole or substantial part, by the above corporate business purpose.

(f) There is no plan or intention by the shareholders of Distributing to sell, exchange,

transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.

(g) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of §4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.

(h) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.

(i) The total adjusted bases and fair market value of the assets transferred to Controlled by Distributing equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.

(j) No property being transferred by Distributing to Controlled has had or will have a § 46 investment credit.

(k) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(l) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

(m) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

(n) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(o) No two parties to this transaction are investment companies as defined in §§368(a)(2)(F)(iii) and (iv).

(p) The distribution is not part of a plan or series of related transactions (within the meaning of § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of Distributing or Controlled.

(q) Distributing is currently an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available

date after the distribution and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

Based solely on the information submitted and the representations as set forth above it is held as follows:

(1) The transfer by Distributing of certain assets and liabilities to Controlled solely in exchange for all of the stock of Controlled and the assumption by Controlled of certain liabilities of Distributing followed by the distribution of the Controlled stock to Shareholder A in exchange for all Shareholder A's Distributing stock, as described above, will be a reorganization within the meaning of §368(a)(1)(D). Distributing and Controlled will each be a "party to a reorganization" within the meaning of §368(b).

(2) Distributing will recognize no gain or loss upon the transfer of its assets and liabilities to Controlled in exchange for Controlled stock and the assumption by Controlled of certain liabilities (§§361(a) and 357(a)).

(3) Controlled will recognize no gain or loss on the receipt of the Distributing assets received in exchange for Controlled stock (§1032(a)).

(4) Controlled's basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transaction (§362(b)).

(5) Controlled's holding period for each asset received from Distributing will include the period during which Distributing held such asset (§1223(2)).

(6) Distributing will recognize no gain or loss on the distribution of the Controlled stock to Shareholder A (§361(c)(1)).

(7) Shareholder A will recognize no gain or loss (and no amount will be included in Shareholder A's income) upon receipt of Controlled stock in exchange for Shareholder A's Distributing stock (§355(a)(1)).

(8) The basis of the Controlled stock received by Shareholder A in the transaction will equal the basis of the Distributing stock surrendered in exchange therefor (§358(a)(1)).

(9) The holding period of the Controlled stock received by Shareholder A in the transaction will include the holding period of the Distributing stock surrendered in exchange therefor, provided Shareholder A held the Distributing stock as a capital asset on the date of the distribution (§1223(1)).

(10) As provided in §312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under §1.312-10(a) of the Income Tax Regulations.

(11) Distributing's momentary ownership of stock of Controlled as part of a reorganization under § 368(a)(1)(D) will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B). Therefore, assuming Controlled will otherwise meet the requirements of a small business corporation under § 1361 of the Code, Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the proposed transaction under any other provision of the Code and Regulations, or about the tax treatment of any conditions existing at the time of, or effects resulting from the proposed transaction. Specifically, no opinion is expressed concerning whether Distributing or Controlled is otherwise eligible to be an S corporation.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file in this office, a copy of this letter has been sent to the taxpayer.

Sincerely yours,
Assistant Chief Counsel (Corporate)
By Ken Cohen
Senior Technical Reviewer, Branch 3